

## SCHEDULARITY IN U.S. INCOME TAXATION AND ITS EFFECT ON TAX DISTRIBUTION

*Henry Ordower*

**ABSTRACT**—Income tax systems in some countries follow primarily schedular models that classify income by type, match it with deductions from the same class, and compute a separate tax on each class. The United States income tax uses a global tax model under which it taxes citizens and permanent residents on their worldwide income without regard to source or character. The United States system is not purely global but includes schedular elements. This Article exposes embedded schedularity in the United States income tax in the three principal areas of investment income, personal services income, and tax free income. The Article tests whether that schedularity enhances or undercuts the tax principles of horizontal and vertical equity that underlie the development of both global and schedular tax systems in advanced economies. Horizontal equity is a straightforward principle and seems an indisputable precept. It requires that like taxpayers incur like tax burdens. The principle of vertical equity is more nuanced and departs from the principle that as one's income increases, one can and should contribute ever larger percentages of that income to supporting governmental services. Vertical equity assumes that the wealthier one is, the less likely it is that an increased tax burden will diminish the individual's welfare in any material way. Conversely, the less wealthy one is, the more likely it is that an increased tax burden will diminish the individual's welfare materially. The vertical equity principle led to the development of the progressive rate structures. While the Article observes that Congress uses schedular elements to accomplish distributional policy goals, initially in order to protect progressivity, more recently schedularity has tended to increase overall regressivity in taxation. The Article concludes that United States taxation seems to be moderately schedular and that schedularity in the United States contributes to regressivity in taxation.

**AUTHOR**—Professor of Law, Saint Louis University School of Law; J.D., M.A., The University of Chicago; A.B., Washington University. Thank you to Margaret McDermott for research assistance, Ilene Ordower for proofreading, and Professor Charlotte Crane for envisioning and organizing the conference and for her thoughtful commentary.

# NORTHWESTERN UNIVERSITY LAW REVIEW

INTRODUCTION .....	906
I. CAPITAL GAIN AND OTHER INVESTMENT INCOME.....	910
A. <i>Capital Gain</i> .....	910
B. <i>Qualified Dividend Income</i> .....	912
C. <i>Imputed Income</i> .....	913
II. INCOME FROM PERSONAL SERVICES .....	915
A. <i>The Earned Income Tax Credit (EITC)</i> .....	915
B. <i>The Regressive Social Security Tax</i> .....	916
C. <i>Compensation Deferrals</i> .....	917
D. <i>Personal Service Income Exclusions and Horizontal Equity</i> .....	918
III. EXCLUSIONS FROM GROSS INCOME .....	920
CONCLUSION .....	922

## INTRODUCTION

The U.S. income tax<sup>1</sup> follows a global model.<sup>2</sup> Global models combine income from all sources into a single taxable income computation.<sup>3</sup> Several economically developed countries, including Sweden,<sup>4</sup> Germany,<sup>5</sup> and

---

<sup>1</sup> The “income tax” in this Article refers to the U.S. federal income tax, subtitle A of the Internal Revenue Code of 1986, as amended, 26 U.S.C. (the Code).

<sup>2</sup> SYLVAIN R.F. PLASSCHAERT, SCHEDULAR, GLOBAL AND DUALISTIC PATTERNS OF INCOME TAXATION 17–24 (1988) (discussing global and schedular tax systems); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 49–50 (1996) (“The United States’ tax system . . . has a nominally global tax system with schedular components.”). Some scholars follow the usage in the foreign tax credit literature and refer to schedularity as “basketing.” E.g., Leandra Lederman, *A Tisket, a Tasket: Basketing and Corporate Tax Shelters*, 88 WASH. U. L. REV. 557 (2011) (recommending increased usage of income baskets to prevent tax sheltering).

<sup>3</sup> I.R.C. § 61(a) (2012) defines gross income as “all income from whatever source derived,” and I.R.C. § 63(a) defines taxable income as gross income less deductions, but, for individuals, I.R.C. § 62 generally separates business deductions from other deductions.

<sup>4</sup> INKOMSTSKATTELAG (Svensk författningssamling [SFS] 1999:1229) (Income Tax Law), Dec. 16, 1999, as amended through Nov. 6, 2013 (Swed.) (hereinafter IL), available at <https://lagen.nu/1999:1229>, identifies three classes of income: Avd. IV. Inkomstlaget Tjänst (Income Class Personal Services), V. Inkomstlaget Näringsverksamhet (Income Class Trade or Business), and VI. Inkomstlaget Kapital (Income Class Capital). Sweden combines the net income from personal services and trade or business into a single tax base under 1 ch. 5 § IL, taxes the combined amount under 65 ch. 3, 5 §§ IL, and applies a separate lower rate to income from capital, 65 ch. 7 § IL. The literature refers to that type of system as a “dual income” tax. Among American scholars recommending a dual income tax for the United States, see Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J.L. & SOC. POL’Y 41, 42–43, 42 n.7 (2010), referring to separation of capital income from labor income where they overlap and citing principal English-language sources on Nordic dual income taxes.

<sup>5</sup> Einkommensteuergesetz [Income Tax Law], Oct. 16, 1934, as amended through Dec. 18, 2013, BGBL. I, § 2 (Ger.), available at <http://www.gesetze-im-internet.de/estg/BJNR010050934.html> (identifying seven classes of income).

Canada,<sup>6</sup> employ a schedular model of taxation that separates income and related expenses into classes and either combines the net income from different classes, but limits the deduction of loss from one class from the income of another, or computes tax separately for some classes.<sup>7</sup> In schedular systems, income not belonging to a specific class is not taxable, while in a global system like the U.S.'s, all income purportedly is taxable.

Despite its appearance, the U.S. income tax system is not purely global. Instead the income tax separates income into several classes (capital gains and losses, for example<sup>8</sup>) to which it applies differing rules and rates in the same way as schedular systems do. This Article identifies and discusses schedular features of the income tax in its treatment of investment income, personal service income, and tax-exempt income. Rather than a uniform global tax on "all income from whatever source derived,"<sup>9</sup> the income tax aggregates several income class computations. Sometimes the income tax also seeks to match and limit deductions by income class.<sup>10</sup>

Whether a tax system is global or schedular is unimportant unless the system's structure results in an unfair distribution of tax burdens among taxpayers. The principles of horizontal and vertical equity express a view of fair tax distribution that underlies the development of both global and schedular income tax systems in advanced economies, including the United States. Horizontal equity contemplates treating like taxpayers alike so that taxpayers with identical economic incomes<sup>11</sup> pay equal amounts of tax.<sup>12</sup> A global system that treats all income alike identifies identical incomes more

---

<sup>6</sup> Income Tax Act, R.S.C. 1985, c. 1, § 117 (5th Supp.) (Can.), as amended through Jan. 1, 2014, available at <http://laws-lois.justice.gc.ca/eng/acts/i-3.3> (identifying four classes of income).

<sup>7</sup> PLASSCHAERT, *supra* note 2, at 17 (defining schedular systems as taxing various types of (net) income separately; global systems as aggregating all types of income and deductions and subjecting the aggregate net income to a single, progressive set of rates; and dualistic and hybrid systems as displaying elements of both schedular and global systems).

<sup>8</sup> I.R.C. §§ 1222, 1(h), 1211 (2012).

<sup>9</sup> *Id.* § 61.

<sup>10</sup> *Id.* § 265(a)(1) (denying a deduction for the expenses of producing tax-exempt income); *id.* § 280A(a), (c)(1) (limiting deductions from the business use of one's personal residence); *id.* § 183 (limiting deductions from income-producing hobby activities).

<sup>11</sup> The classic Haig-Simons definition of income is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938). Professor Simons acknowledges that payments in kind and imputed value from consumption of one's own services and property present formidable problems of valuation. *Id.* at 52-54; see also Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX: A SERIES OF LECTURES DELIVERED AT COLUMBIA UNIVERSITY IN DECEMBER, 1920, at 1, 5-6 (Robert Murray Haig ed., 1921) (discussing income in kind).

<sup>12</sup> WILLIAM A. KLEIN, POLICY ANALYSIS OF THE FEDERAL INCOME TAX: TEXT AND READINGS 7 (1976). But see James Repetti & Diane Ring, *Horizontal Equity Revisited*, 13 FLA. TAX REV. 135 (2012) (arguing that horizontal equity has no normative content and is only part of vertical equity).

readily than a schedular system in which incomes are identical only if the amounts of income in each class are identical. By applying different rates to different income classes, schedular tax systems may cause identical amounts of economic income to incur different taxes thereby rendering implementation of horizontal equity elusive.

The principle of vertical equity informs the development of progressive taxation characteristic of the personal income tax systems in advanced economies.<sup>13</sup> Vertical equity contemplates that fair distribution of income tax burdens requires high-income taxpayers to pay disproportionately more of their income in tax than lower income taxpayers do. The mechanism for that disproportionality is progressively higher rates so that as a taxpayer's income increases, the taxpayer pays an increasing percentage of her income in tax.<sup>14</sup> The United States uses progressive rate brackets that apply each higher rate only to income in excess of the maximum income to which the previous bracket applies.<sup>15</sup> Consistent with this progressivity principle, the maximum marginal income tax rate reached more than ninety percent in the 1950s.<sup>16</sup> Income tax rate progression from the minimum statutory rate of zero to the maximum marginal rate was more than fifty percentage points greater in the 1950s than it is today.<sup>17</sup>

Since the reduction of the maximum rate from 70% to 50% in 1981,<sup>18</sup> progressive taxation has been under siege. Legislation in the United States and Europe has compressed marginal brackets and reduced maximum rates of tax.<sup>19</sup> Economic globalization and accompanying international tax

<sup>13</sup> The classic work cataloging arguments for progressive taxation is WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953).

<sup>14</sup> RICHARD A. WESTIN, *WG&L TAX DICTIONARY* 835 (2000). See I.R.C. §§ 2001, 2501–2502 (the progressive gift and estate tax applies the principle to wealth).

<sup>15</sup> I.R.C. § 1(a)–(e) (applying marginal brackets to taxable income).

<sup>16</sup> *Id.* § 11 (1939) (3% normal tax); *id.* § 12 (graduated surtax of 17% to 88% or 89%), *amended by* Revenue Act of 1951, Pub. L. No. 82-183, 65 Stat. 452; *id.* § 1 (1954) (imposing a single graduated rate schedule ranging from 20% to 91% on incomes exceeding \$200,000).

<sup>17</sup> I.R.C. § 1(a)–(e) (2012) (39.6% maximum). There always has been a zero marginal rate. The differential in rate spread from the 1950s to the present peaked at more than 60% when the maximum marginal rate under I.R.C. § 1(a)–(e) following amendment by the Tax Reform Act of 1986, sec. 101(a), § 1(a)–(e), Pub. L. No. 99-514, 100 Stat. 2085, 2096–97, dipped to 28%. The earned income credit under I.R.C. § 32 causes today's spread to be larger because the effective tax rate for some low-wage taxpayers is negative. Despite those negative effective rates, lower rates of tax and smaller degrees of progression apply to high-income taxpayers than applied from the 1950s until 1986.

<sup>18</sup> I.R.C. § 1 imposed a maximum rate of 70% after 1969 subject to a 50% maximum rate on earned income under I.R.C. § 1348, until the enactment of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, sec. 101(a), § 1(a)–(e), 95 Stat. 172, 176–82. Further rate reduction followed in 1986. *Supra* note 17.

<sup>19</sup> OECD, *TAX POLICY STUDIES NO. 13: FUNDAMENTAL REFORM OF PERSONAL INCOME TAX* 7 (2006) (identifying trends in tax rates in OECD countries); GREGG A. ESENWEIN & JANE G. GRAVELLE, CONG. RESEARCH SERV., *RL32603, THE FLAT TAX, VALUE-ADDED TAX, AND NATIONAL RETAIL SALES TAX: OVERVIEW OF THE ISSUES* (2004) (identifying issues and distributional concerns in tax restructuring).

competition have exerted steady tax rate reduction pressure on income taxes and increasing revenue dependence on more regressive value-added taxes.<sup>20</sup> Individuals at the upper end of the income and wealth spectra often have the ability to move and hide capital offshore when their residence jurisdiction (such as the United States) imposes tax on worldwide income.<sup>21</sup> Every year some high-income individuals expatriate to low-tax jurisdictions.<sup>22</sup> Major corporations shift income to subsidiaries in lower tax jurisdictions in order to avoid or defer the imposition of the U.S. corporate income tax.<sup>23</sup> Proposals to reduce and flatten rates tend to preserve minimal progressivity in the form of a zero rate for some low-income individuals, but value-added taxes and wage taxes often lack a zero rate at the low end.

This Article argues that schedularity in the income tax diminishes progressivity and primarily favors high- rather than moderate- or low-income taxpayers, for example, by providing deferral opportunities for personal service income<sup>24</sup> and preferential rates for some investment income.<sup>25</sup> A few schedular features, however, including the earned income credit<sup>26</sup> and probably the exclusion of meals and lodging,<sup>27</sup> benefit lower income taxpayers. And the income tax turned to schedularity on several occasions to combat investment structures that high-income taxpayers use to diminish their tax liability.<sup>28</sup>

---

<sup>20</sup> For example, in Sweden the value-added tax increased from 16.58% to 21.14% and the personal income tax decreased from 29.86% to 25.26% of revenues from 2000 to 2010. EUROPEAN COMM'N TAXATION & CUSTOMS UNION, [http://ec.europa.eu/taxation\\_customs/tedb/taxSearch.html](http://ec.europa.eu/taxation_customs/tedb/taxSearch.html) (search "VAT" and check "Sweden"; then click the hyperlink for "VAT"); *id.* (search "personal income tax" and check "Sweden"; then click the hyperlink for "Personal income tax—National and Local income tax").

<sup>21</sup> The Internal Revenue Service (IRS) sought to identify and tax income from accounts and complex structures that conceal income otherwise taxable in the United States. *See* Henry Ordower, *The Culture of Tax Avoidance*, 55 ST. LOUIS U. L.J. 47, 123–25 (2010). In order to provide expanded jurisdiction and enforcement tools to the IRS with respect to offshore accounts, Congress enacted the Foreign Account Tax Compliance Act as part of the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §§ 501–502, 124 Stat. 71, 97–98 (2010) (codified at I.R.C. §§ 1471–1474) (requiring 30% withholding on payments to foreign persons who do not provide information on U.S. beneficial ownership).

<sup>22</sup> *See* Quarterly Publication of Individuals, Who Have Chosen to Expatriate, 77 Fed. Reg. 25,538 (Apr. 30, 2012) (listing 1st quarter 2012 expatriates).

<sup>23</sup> *See* CONG. BUDGET OFFICE, OPTIONS FOR TAXING U.S. MULTINATIONAL CORPORATIONS (2013), [http://www.cbo.gov/sites/default/files/cbofiles/attachments/43764\\_MultinationalTaxes\\_rev02-28-2013.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/43764_MultinationalTaxes_rev02-28-2013.pdf) (discussing, *inter alia*, deferral).

<sup>24</sup> I.R.C. § 401 (pension and profit-sharing plans).

<sup>25</sup> *E.g.*, *id.* § 103 (interest from state and local obligations taxed at a zero rate); *id.* § 1(h) (net capital gain taxed at a maximum 20% rate).

<sup>26</sup> *Id.* § 32.

<sup>27</sup> *Id.* § 119.

<sup>28</sup> The label for many of those investment structures is "tax shelters." *See generally* Ordower, *supra* note 21, at 55–68 (describing the historical structure of tax shelters and discussing public perceptions of tax rates and fairness and expressing general willingness to avoid and often evade taxes). The maximum

As it identifies embedded schedularity in the U.S. income tax, this Article examines the impact of schedularity on horizontal and vertical equity. Part I examines capital gain and other investment income. Part II focuses on income from personal services and identifies multiple subclasses of personal service income. Part III considers tax-exempt income as a schedular class. This Article concludes that U.S. taxation is moderately schedular with schedularity contributing to both regressivity and dissimilar treatment of similar taxpayers.

## I. CAPITAL GAIN AND OTHER INVESTMENT INCOME

Schedularity in treatment of investment income favors wealthier taxpayers who have funds to invest and contributes to increasing wealth disparity in the United States.<sup>29</sup>

### A. Capital Gain

The most prominent and enduring schedular feature of the income tax is its capital gain preference<sup>30</sup> that separates net capital gain<sup>31</sup> from other sources of income, and taxes it at lower rates than ordinary income. Except for a brief period during the late 1980s,<sup>32</sup> the capital gain preference has been a mainstay of the income tax.<sup>33</sup> Consistent with the schedular net

---

tax on earned income, I.R.C. § 1348 (1954), limited the maximum marginal rate of tax on income from labor to 50% to discourage taxpayers from sheltering their service income with tax-advantaged investments that would yield maximum 70% rate investment income after several years when they no longer yielded deductions in excess of income. The maximum tax was far less successful than the passive activity loss limitation, *id.* § 469 (2012), a schedular matching provision that limits a taxpayer's deductible losses from passive activities to her includable income from passive activities. Passive activities are businesses in which the taxpayer does not participate materially. *Id.* § 469(c)(1). Most tax shelters were loss-and-tax-credit-generating trade or business activities in which the target investor would not participate actively.

<sup>29</sup> THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R42131, CHANGES IN THE DISTRIBUTION OF INCOME AMONG TAX FILERS BETWEEN 1996 AND 2006: THE ROLE OF LABOR INCOME, CAPITAL INCOME, AND TAX POLICY (2011) (identifying increasing wealth disparity among Americans). Additional examples of favored investment income appear in the exempt income discussion *infra* Part III.

<sup>30</sup> Compare I.R.C. § 1(h)(1)(D)–(F) (reducing the maximum rate for individuals on net capital gain to 20%, 25%, or 28% depending upon the underlying property), with I.R.C. § 1(a)–(e) (imposing a general maximum rate of 39.6% on individual taxpayers).

<sup>31</sup> *Id.* § 1222(1) (defining net capital gain as “the excess of the net long-term capital gain . . . over the net short-term capital loss”).

<sup>32</sup> The Tax Reform Act of 1986, sec. 301, Pub. L. No. 99-514, 100 Stat. 2085, 2216–18, temporarily eliminated the preferential treatment of net capital gains.

<sup>33</sup> I.R.C. § 117(c) (1939), amended by Revenue Act of 1951, sec. 123, Pub. L. No. 82-183, 65 Stat. 452, 470; *id.* § 1202 (1954) (allowing individual taxpayers a 50%, and, beginning in 1978, 60%, deduction of their net capital gains). From 2003 to 2013, the maximum rate on net capital gain was 15%, 25%, or 28%. *Id.* § 1(h)(1)(C)–(E) (2000 & Supp. III); *id.* § 1(h)(1)(C)–(E) (2012).

capital gain preference is the limited deductibility of capital losses,<sup>34</sup> the capitalization rule, which requires taxpayers to include expenditures for the acquisition and improvement of capital assets in those assets' tax bases rather than allowing a current deduction for the expenditures.<sup>35</sup>

The capital gain preference is not purely schedular, as it does not separate capital gain from other income in all tax computations. For example, a taxpayer having an ordinary loss<sup>36</sup> and net capital gain in the same year would offset her capital gain with the ordinary loss rather than carrying the ordinary loss forward to offset ordinary income in the future.<sup>37</sup> The net capital gain consumes the tax benefit of the ordinary loss with income that otherwise would be taxable at a preferential rate.<sup>38</sup> The same is not true for net capital losses: an individual taxpayer may deduct only \$3000 of net capital loss from her ordinary income per tax year<sup>39</sup> but may carry any additional net capital loss forward indefinitely.<sup>40</sup>

Two arguments stand out among reasons to favor capital gain<sup>41</sup> in the U.S. realization-based income tax system under which taxpayers do not take gain or loss on an asset into account until they dispose of the asset.<sup>42</sup> First, the realization requirement discourages taxpayers from selling assets and recognizing gain even in instances where change of ownership would

<sup>34</sup> *Id.* § 1211 (limiting the taxpayer's deduction of capital losses in a tax year to the amount of the taxpayer's capital gains in the same year plus \$3000 per year for individuals); *id.* § 1212(b) (allowing an unlimited carryforward of capital losses).

<sup>35</sup> *Id.* §§ 263, 263A (capital expenditures and capitalization); *id.* §§ 1011–1012 (basis and adjusted basis, the amounts taxpayers use to determine gain or loss under I.R.C. § 1001 and depreciation under I.R.C. § 167).

<sup>36</sup> *Id.* § 65 (defining ordinary loss as including “loss from the sale or exchange” of noncapital property).

<sup>37</sup> *Id.* § 64 (defining ordinary income as including gain that is neither capital nor 1231); *id.* § 172 (providing rules for carrying net ordinary losses forward to subsequent and backward to previous taxable years).

<sup>38</sup> *Id.* § 1(h).

<sup>39</sup> *Id.* § 1211(b) (limiting the deduction of capital losses to the amount of capital gains plus \$3000 per year). Under § 1211(a) corporations may deduct capital losses only from capital gains.

<sup>40</sup> *Id.* § 1212(b) (permitting individuals to carry an excess net capital loss as a capital loss into the next tax year, thereby renewing the loss indefinitely). Corporations, on the other hand, may carry capital losses back three years and forward ten years before they expire. *Id.* § 1212(a)(1).

<sup>41</sup> Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957) (summarizing and refuting a number of common arguments for not taxing capital gains).

<sup>42</sup> I.R.C. § 1001(a) (measuring the gain or loss from the disposition of property); *id.* § 1001(c) (“recogniz[ing],” that is, including in income, only realized gains and losses from the “sale or exchange of property” in income). Realization may be a constitutional mandate. *See Eisner v. Macomber*, 252 U.S. 189, 207–09 (1920) (establishing that the Sixteenth Amendment prohibits taxing gain before realization); *see also* Ilan Benshalom & Kendra Stead, *Realization and Progressivity*, 3 COLUM. J. TAX L. 43 (2011) (arguing that the realization requirement for investment assets prevents progressivity in taxation).

facilitate economically efficient use of the assets.<sup>43</sup> The realization requirement enables taxpayers to defer tax on gain indefinitely and even permanently if they hold the property until they die.<sup>44</sup> Second, capital gains are not income because they result from inflation rather than real economic gain.

Substituting annual inclusion of increases and decreases in property values for the realization requirement would eliminate the large buildups of untaxed appreciation that discourage taxpayers from selling their property. While Congress has enacted annual gain and loss inclusion for commodities positions and dealer-held securities,<sup>45</sup> broader proposals to include appreciation for all property annually have not received legislative support.<sup>46</sup>

Annual inclusion of appreciation would weaken the inflation argument significantly as well. Inflation gain also affects wage levels and other investment returns, but it tends to be less visible on an annual basis because it does not accumulate as it does when property is held for many years.

### B. *Qualified Dividend Income*

In 2003, Congress extended the lowest rate category of net capital gain to most corporate dividend distributions.<sup>47</sup> This preferential treatment of dividends reflects the continuing debate surrounding double taxation in the

---

<sup>43</sup> Opportunities to exchange properties without immediate gain recognition, including like-kind exchanges under I.R.C. § 1031(a)(1) and transfers of assets to entities in exchange for interests in those entities under I.R.C. § 351(a) (corporations) and I.R.C. § 721(a) (partnerships and, as classified by Treas. Reg. § 301.7701-3(b)(i) (2013), limited liability companies), ameliorate, but do not eliminate, this problem.

<sup>44</sup> I.R.C. § 1014(a)(1) (causing property to take a new basis equal to the property's value on its owner's date of death). Taxpayers may monetize the gain without paying tax by using the property as security for a loan.

<sup>45</sup> *Id.* § 1256(a)–(b) (applying accrual taxation to commodities positions); *id.* § 475(a) (mark to market for securities dealers).

<sup>46</sup> See, e.g., David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1113–17 (1986) (proposing annual inclusion of appreciation and depreciation in income). Annual inclusion of appreciation arguably violates the constitutional realization requirement. See *Eisner*, 252 U.S. at 207–08. I.R.C. § 1256(a) characterizes annual gain accrual as 60% long term even if the taxpayer has held the position for less than one year. This gain characterization rule is beneficial to commodities traders and may account for acceptance of accrual taxation without challenge. Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market*, 13 VA. TAX REV. 1, 94–95 (1993).

<sup>47</sup> Section 302(a) of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752, 760–61, temporarily added I.R.C. § 1(h)(11) to the Code (reducing the maximum rate on qualifying corporate dividends to the net capital gain rate by adding qualified dividends to net capital gain for purposes of computing the individual taxpayer's tax). See *id.* § 303 (sunset provision). The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102(a), 126 Stat. 2313, 2318 (2013), made I.R.C. § 1(h)(11) permanent. Capital losses are not deductible against qualifying dividend income. I.R.C. § 1211 limits deductibility of capital losses to the amount of capital gains plus, in the case of individuals, \$3000 per year.



corporate income tax.<sup>48</sup> Traditional corporate tax structures tax the corporation when it earns income<sup>49</sup> and tax the shareholders when they receive dividend distributions from the corporation's earnings.<sup>50</sup> The 1986 repeal of certain Internal Revenue Code provisions that allowed corporations to distribute appreciated assets to their shareholders without recognizing their corporate-level gain set the stage for the reduction in the income tax rate on corporate dividends.<sup>51</sup> Since the repeal, all corporate distributions of appreciated property are subject to a corporate-level tax.<sup>52</sup> That full corporate-level tax and the availability of entities that offer limited liability to their owners but are not subject to tax at the entity level<sup>53</sup> bolstered the argument that reducing the shareholder-level tax on distributed corporate earnings was appropriate.

### C. Imputed Income

Like wages, the return a taxpayer receives on her invested capital is gross income and taxable.<sup>54</sup> Rent the taxpayer pays with that investment return for use of her dwelling is not deductible.<sup>55</sup> Yet, if the taxpayer invests her capital in a dwelling for her personal and family use, the value of that use, for which the taxpayer otherwise would have to pay nondeductible rent, is not includable in her gross income. This nonstatutory exclusion of imputed income from the owner's use of her dwelling is less visible in its schedularity than the capital gain preference but significant in its distributional impact.

---

<sup>48</sup> 1 BORIS I. BITTKER & JAMES S. EUSTICE WITH THE COLLABORATION OF GERSHAM GOLDSTEIN, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.08[1] (Thomson Reuters/WG&L 7th ed. 2013) (1959) (discussing integration proposals to end double taxation).

<sup>49</sup> I.R.C. § 11(a).

<sup>50</sup> *Id.* § 316(a) (defining dividend as a distribution from a corporation's earnings and profits); *id.* § 312(a) (adjusting earnings and profits in certain instances); *id.* § 301(c) (including dividends in the shareholders' incomes). Where one corporation owns shares of another corporation and receives dividends from that second corporation, the dividends-received deduction prevents the imposition of another full corporate-level tax on the dividend-distribution income. *Id.* § 243(a) (recipient may deduct 70%–100% of the dividends it receives from other corporations).

<sup>51</sup> See *id.* §§ 311(a), 336(a), 337(a) (1982) (before their amendment by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085). The rule that corporations do not recognize gain when they distribute appreciated property in kind to their shareholders arose from the decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 206 (1935), which held that a corporation did not recognize gain on the distribution of appreciated property as a dividend.

<sup>52</sup> See I.R.C. § 311(b) (2012) (treating distribution of appreciated property as a sale for fair market value). Exceptions exist for distribution of the corporation's own stock under I.R.C. § 1032(a) and stock of other corporations pursuant to a plan of reorganization under I.R.C. § 361(a).

<sup>53</sup> Treas. Reg. § 301.7701-3(b) (2013) (defining multiple owner eligible entities, including limited liability companies, as partnerships that are tax transparent under I.R.C. § 701).

<sup>54</sup> I.R.C. § 61(a) (defining gross income). Exceptions apply for some investments. See, e.g., *id.* § 103(a) (tax-exempt bonds).

<sup>55</sup> *Id.* § 262(a) (no deduction for family or living expenses).

Assuming no loss in value of the residence,<sup>56</sup> owners pay for the use of their residences by foregoing the periodic, taxable investment return they otherwise might receive from an alternative investment of their capital. Yet, owners are not taxed on the value of their use or the income they forego. Historical increase or stability in housing value sets housing apart from other owner-used property—automobiles, for example—that economically depreciate over time.

Not imputing income from the owner's use of her property creates a strong economic bias in favor of home ownership over home rental.<sup>57</sup> In other contexts in which one foregoes income from capital, a taxable market exchange is likely to be present. For example, a property owner who provides rent-free use of property to an employee in exchange for the employee's services<sup>58</sup>—a market exchange of property use for services—must include income under the exchange equivalency doctrine.<sup>59</sup> Similarly, lending money without interest to an employee in exchange for services—a market exchange—or to a family member—a gift—results in imputed interest income to the lender.<sup>60</sup>

The costs and expenses of producing income that is exempt from tax are not generally deductible from the taxpayer's other taxable income.<sup>61</sup> However, some expenses related to producing imputed income from use of one's residence remain deductible despite exclusion of the foregone income. Both the interest the owner pays to acquire and hold the residence<sup>62</sup> and the real property taxes that state and local governments impose on the property<sup>63</sup> are deductible.

Poor- and moderate-income individuals tend to be renters, not owners. While many middle-income individuals enjoy the benefits of home ownership, the wealthier the individual, the more valuable his home and its use value is likely to be.<sup>64</sup> Without any increase in income tax, the wealthier

---

<sup>56</sup> *Median Home Values: Adjusted to 2000 Dollars*, U.S. CENSUS BUREAU, [http://www.census.gov/housing/census/data/values/values\\_adj.txt](http://www.census.gov/housing/census/data/values/values_adj.txt) (last visited May 10, 2014) (showing climbing median home values from 1940 to 2000).

<sup>57</sup> Avoiding rental expense without relinquishing use of the property is income.

<sup>58</sup> This is subject to an exception for lodging provided for the employer's convenience on the employer's business premises under I.R.C. § 119(a), discussed *infra* Part II.D. Provision of rent-free use of property to a family member as a gift, however, has not attracted a tax.

<sup>59</sup> *Phila. Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Ct. Cl. 1954) (holding that an exchange at arm's length means that the values of the exchanged property interests must be equal).

<sup>60</sup> I.R.C. § 7872 (imputing interest on low- and no-interest loans). Judicial decisions before enactment of I.R.C. § 7872 in 1984 held that a lender was free to lend without imputation of income. See, e.g., *Dean v. Comm'r*, 35 T.C. 1083, 1090 (1961). Section 172(a) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 699–703, added § 7872 to the Code.

<sup>61</sup> I.R.C. § 265(a)(1) (denying a deduction for the expenses of producing tax-exempt income).

<sup>62</sup> *Id.* § 163(h)(2)(D) (allowing a deduction for qualified residence interest).

<sup>63</sup> *Id.* § 164(a)(1).

<sup>64</sup> See Rachel E. Dwyer, *The McMansionization of America? Income Stratification and the Standard of Living in Housing, 1960–2000*, 27 RES. SOC. STRATIFICATION & MOBILITY 285, 294

one is, the more economic income one has under a comprehensive measure that includes that imputed use value.<sup>65</sup>

## II. INCOME FROM PERSONAL SERVICES

While the schedularity of investment income primarily favors higher income-and-wealth taxpayers,<sup>66</sup> schedularity of personal service income often benefits low- and moderate-income individuals. On balance, however, the separation of personal service income from other income categories also tends to favor higher income-and-wealth taxpayers. In addition, tax advantages for the schedular class of personal service income frequently violate horizontal equity norms.

### A. The Earned Income Tax Credit (EITC)

The EITC<sup>67</sup> allows a reduction of the individual's tax liability as a function of the taxpayer's personal service income amount and number of dependent children.<sup>68</sup> Since the taxpayer receives a payment from the government of any amount by which the EITC exceeds her tax liability,<sup>69</sup> the EITC effectively creates negative income tax brackets for personal service income. The EITC is schedular and applies only to a narrow band of inflation-adjusted, personal service income.<sup>70</sup> Income of all types—not just personal service income—exceeding an inflation-adjusted amount, which is a function of filing status and the number of qualifying children,

---

(2009) (“[A]ll non-White racial groups . . . became less likely to own big houses over time. This result is particularly striking given other evidence of (slightly) lessening racial stratification in housing after the passage of Fair Housing legislation . . .”); *id.* at 298 (“[H]ousing consumption inequality increased along with income inequality . . .”).

<sup>65</sup> See Richard Goode, *Imputed Rent of Owner-Occupied Dwellings Under the Income Tax*, 15 J. FIN. 504, 512–13 (1960) (discussing the economic impact of taxation of imputed rental income on owner-occupied dwellings and accepting as an economic premise that owner use of owned property generates economic income to the owner).

<sup>66</sup> See *supra* Part I. Double taxation of corporate profits, *see supra* note 48 and accompanying text, ameliorates the regressive impact of the preferences to some degree.

<sup>67</sup> I.R.C. § 32(a)(1) (applying the credit to earned income only); *id.* § 32(c)(2)(A) (defining earned income as income from performance of services).

<sup>68</sup> *Id.* § 32(a)–(b). As temporarily extended until the end of 2017 by the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 103(c), 126 Stat. 2313, 2319–20 (2013), the credit amount is 7.65%, 34%, 40%, or 45% of the taxpayer's personal service income for taxpayers having zero, one, two, or three or more children, respectively. I.R.C. § 32(b)(1)(A), (b)(3)(A). The statute uses the term “qualifying child” defined substantially as a dependent child under I.R.C. § 152(c). *Id.* § 32(c)(3)(A). After 2017, the 45% credit for three or more children disappears. *Id.* § 32(b)(3)(A).

<sup>69</sup> The EITC is a refundable credit and not limited, as are other credits, to the taxpayer's tax liability. I.R.C. § 6401(b)(1) (treating excess refundable credits as overpayments of tax); *id.* § 6402(a) (requiring the IRS to refund overpayments).

<sup>70</sup> From \$1 to not more than \$13,430 in 2013. Rev. Proc. 2013-15, 2013-5 I.R.B. 444, 446–47 (showing inflation adjustments for certain tax rules); I.R.C. § 32(b)(2) (establishing maximum amounts of income for the credit and minimum amounts for the phaseout).

reduces the taxpayer's EITC.<sup>71</sup> While the schedular EITC benefits many low-income taxpayers, the maximum credit cap and the reduction as a taxpayer's income increases causes the tax rates in certain low- and moderate-income ranges to be steeply progressive.<sup>72</sup>

### B. *The Regressive Social Security Tax*

The Social Security tax<sup>73</sup> and complementary self-employment tax<sup>74</sup> are schedular in that they tax personal service income only.<sup>75</sup> Both taxes have two-bracket, regressive rate structures<sup>76</sup> applying a positive flat rate to personal service income up to a cap<sup>77</sup> and a zero rate to all personal service income in excess of the cap.<sup>78</sup> Moreover, certain compensatory benefits that favor higher income employees, including employer-funded retirement plans<sup>79</sup> and fringe benefits,<sup>80</sup> are not subject to the Social Security tax.<sup>81</sup>

<sup>71</sup> I.R.C. § (32)(a)(2), (b), (j). The statute refers to the reduction as a phaseout. *Id.* § 32(a)(2)(B).

<sup>72</sup> For example, the income tax rate increases forty-five percentage points on each additional dollar of income a taxpayer with three children receives in excess of \$13,430 because the additional dollar no longer qualifies for the 45% EITC. And for each additional dollar in excess of \$17,530 (\$22,870 for married taxpayers filing jointly), the rate increases again by 21.06%. *Id.* § 32(b) (credit and phaseout percentages and thresholds); Rev. Proc. 2013-15, 2013-5 I.R.B. 444, 447 (showing inflation adjustments). Computation of the earned income credit slightly favors wage earners over self-employed individuals up to the maximum credit because self-employed individuals diminish the base for computation of the credit by the amount of their business expenses and wage earners do not. I.R.C. § 32(c)(2)(A) (defining earned income as wages plus net earnings from self-employment); *see id.* § 1402(a) (defining net earnings from self-employment).

<sup>73</sup> I.R.C. § 3101(a) (imposing the old-age, disability, and survivors tax on wages).

<sup>74</sup> *Id.* § 1401(a) (imposing the old-age, disability, and survivors tax on self-employment income).

<sup>75</sup> Some employees are exempt from the tax and do not receive Social Security benefits. *Id.* § 3121(b) (defining employment and exempting certain employment); *id.* § 3101(a) (imposing Social Security taxes only on wages earned from employment as defined in § 3121(b)).

<sup>76</sup> *See* HUNGERFORD, *supra* note 29, at 6 (addressing the regressivity of the tax).

<sup>77</sup> I.R.C. § 3101 (imposing on both the employer and the employee a 6.2% tax on the employee's wages); *id.* § 1401 (imposing a 12.4% tax on net earnings from self-employment income but allowing a deduction of half the tax under I.R.C. § 62(a)(1) as a trade or business expense under I.R.C. § 164(f)). The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102(a), 126 Stat. 2313, 2318 (2013), did not extend the temporary reduction in the wage and self-employment tax but made permanent the regressive preferential rate for qualified dividends.

<sup>78</sup> I.R.C. § 3121(a)(1) (determining the wage cap under section 230 of the Social Security Act, 42 U.S.C. § 430(b) (2006), currently \$113,700, Cost-of-Living Increase and Other Determinations for 2013, 77 Fed. Reg. 65,754 (Oct. 30, 2012)); *id.* § 1402(b)(1) (determining the self-employment income cap). The tax also does not apply to a *de minimis* amount of income. *Id.* § 1402(b)(2). The Medicare tax under I.R.C. §§ 3101(b), 1401(b), and 1411(a) primarily reaches personal service income, but differs from the Social Security tax because it has no cap, includes an additional positive bracket applicable to higher incomes, and now imposes an additional 3.8% tax on net investment income in excess of a threshold.

<sup>79</sup> *Id.* § 3121(a)(5); *see infra* Part II.C.

<sup>80</sup> I.R.C. § 3121(a)(20) (excluding many I.R.C. § 132 items from the Social Security tax base); *see infra* Part II.D.

<sup>81</sup> I.R.C. § 3121(a).

That the employee arguably bears the economic burden of all or part of the employer's share of the tax through lower wages than the employee otherwise might receive absent the employer's tax makes the Social Security tax even more regressive.<sup>82</sup> While the formula for Social Security benefits ameliorates the regressivity of the Social Security tax to a limited degree,<sup>83</sup> the zero rate applicable to personal service income exceeding the Social Security threshold and to all income not from personal services favors higher income taxpayers.

### C. Compensation Deferrals

Every taxpayer may postpone tax inclusion of a part of his current personal service income by transferring it to a statutorily qualified retirement plan.<sup>84</sup> While the transfer defers inclusion in income, the transfer also defers consumption of the income to the year in which the taxpayer withdraws those amounts from the plan.<sup>85</sup> The lower one's income, however, the less likely it becomes that the taxpayer will utilize the deferral opportunity because he must use all his income for current necessities.<sup>86</sup> Although neutral on their face, statutory deferral opportunities strongly favor higher income taxpayers who do not need all of their income for current necessities and may defer personal service income. Accordingly, the disproportional utilization of compensation deferral opportunities is regressive. Even the individual retirement account (IRA),<sup>87</sup> which Congress intended to target moderate-income or middle-class individuals, yields its benefits primarily to high-income individuals.<sup>88</sup>

---

<sup>82</sup> S. REP. NO. 94-36, at 11 (1975), *reprinted in* 1975 U.S.C.C.A.N. 54, 64 (acknowledging that the employee bears both the employee's and the employer's share of the Social Security tax).

<sup>83</sup> U.S. GEN. ACCOUNTING OFFICE, GAO-04-747, SOCIAL SECURITY: DISTRIBUTION OF BENEFITS AND TAXES RELATIVE TO EARNINGS LEVEL 14, 20–21 (2004) (observing that although Social Security benefit formulas are designed to be progressive, the regressivity of Social Security taxes significantly reduces this progressive effect).

<sup>84</sup> I.R.C. § 219 (West 2013) (deduction for contribution to an individual retirement account (IRA)); *id.* § 401(k) (2012) (elective deferral to a qualified retirement plan).

<sup>85</sup> *See* I.R.C. § 72(a) (2012) (taxing amounts received from deferrals to retirement plans as annuities). If someone other than the one who earned the income receives the distributions because of the earner's death, the income remains ordinary income under I.R.C. § 691(a)(1), which discusses treatment of income with respect to a decedent.

<sup>86</sup> *See* BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, CONSUMER EXPENDITURE SURVEY, 2012, tbl.1202, <http://www.bls.gov/cex/2012/combined/income.pdf>.

<sup>87</sup> *Supra* note 84.

<sup>88</sup> THOMAS L. HUNGERFORD & JANE G. GRAVELLE, CONG. RESEARCH SERV., RL30255, INDIVIDUAL RETIREMENT ACCOUNTS (IRAS): ISSUES AND PROPOSED EXPANSION 16–17 (2012).

*D. Personal Service Income Exclusions and Horizontal Equity*

While the schedular separation of personal service income from other income types violates vertical equity principles,<sup>89</sup> exclusions of certain types of personal service income violate horizontal equity principles even if they do not violate vertical equity principles directly. Consider two taxpayers who receive total compensation of \$100,000 each. The first taxpayer directs no compensation into a cafeteria plan<sup>90</sup> and receives no part of her compensation in fringe benefits.<sup>91</sup> The second directs \$4000 into a cafeteria plan and receives \$1000 worth of excludable fringe benefits. The taxpayers receive identical amounts of economic income from their personal services but unequal amounts of includable gross income.<sup>92</sup> Gross income from services for the first taxpayer is \$100,000 and \$95,000 for the second. The second taxpayer will pay a smaller amount of tax than the first. Since the employee's direct purchase of the cafeteria plan or fringe benefit items would yield a smaller or no deduction, the exclusions favor taxpayers whose employers provide the benefits. The exclusions are unique to income from services.

Much noncash personal service income is not subject to tax at all.<sup>93</sup> These income exclusions do not target a specific income class and may prohibit discrimination in favor of highly compensated employees.<sup>94</sup> Some exclusions tend to benefit low- and moderate-income employees in greater numbers than high-income employees.<sup>95</sup> All those exclusions, however, benefit only those employees whose employers provide the nontaxable benefits. The exclusions are not available to the class of self-employed individuals. And taxpayers who pay for like items may not claim a corresponding deduction.<sup>96</sup>

Exclusions of income from personal services may benefit higher income taxpayers as employers even when lower income taxpayers are the primary recipients of the nontaxable benefits. For example, the cost of providing excludable meals and lodging in kind to an employee may be smaller than the additional wage the employer might have to pay to enable

---

<sup>89</sup> See *supra* Part II.B.

<sup>90</sup> I.R.C. § 125 (cafeteria plans consist of excludable benefits such as medical expenditures, for which deductions are available under I.R.C. § 213(a), and childcare expenses, for which a limited credit is available under I.R.C. § 21(a)).

<sup>91</sup> *Id.* § 132 (excludable fringe benefits including parking, public transit passes, gym use, employee discounts, etc.).

<sup>92</sup> *Id.* § 61.

<sup>93</sup> *E.g., id.* § 119(a) (meals and lodging); *id.* § 132 (fringe benefits); *id.* § 3121(a)(19), (20) (Social Security tax exclusion).

<sup>94</sup> *E.g., id.* § 132(j)(1) (requiring that no-additional-cost fringe benefits and employee discounts be available to a class of employees that does not favor highly compensated individuals).

<sup>95</sup> *E.g., id.* § 119(a) (excluding meals and lodging). Low-wage household workers often receive meals and housing.

<sup>96</sup> *Id.* § 262(a) (personal, living, and family expenses not deductible).

the employee to buy those items from third parties with nondeductible dollars.<sup>97</sup> Provision of meals also may enhance the employer's profitability by keeping employees near their workstations. In some businesses, the employee's constant availability for the employer's needs is indispensable.<sup>98</sup> Nevertheless, meals and lodging do benefit the employee and are income, even if their value to the employee is difficult to determine. The exclusion incidentally disserves some low-paid workers who might receive a larger earned income credit<sup>99</sup> and enhanced Social Security benefits when they reach retirement age if the value had been includable.<sup>100</sup>

Other excludable fringe benefits<sup>101</sup> similarly remain free from Social Security and Medicare taxes<sup>102</sup> and do not count toward the earned income credit.<sup>103</sup> Fringe benefits include items to improve the quality of the working environment,<sup>104</sup> enable the employee to consume the employer's services without cost,<sup>105</sup> allow the employee to purchase goods the employer sells at a price lower than that offered to the public,<sup>106</sup> and subsidize the employee's commuting cost.<sup>107</sup> Absent the statutory exclusion, employees would include the fair market value of noncash compensation they receive.<sup>108</sup> Excludable benefits, also free from the employer's share of Social Security and Medicare taxes,<sup>109</sup> may enhance the attractiveness of a position to an employee at a lower wage than the

---

<sup>97</sup> *Id.* For example, this was likely the case for the resort that employed the taxpayer in the leading pre-statutory exclusion meals-and-lodging case, *Benaglia v. Commissioner*, 36 B.T.A. 838, 840 (1937), *acq.* 1940-1 C.B. 1 (holding that gross income does not include meals and lodging provided to the resident manager of a luxury resort and his family).

<sup>98</sup> Babysitting, for example.

<sup>99</sup> I.R.C. § 32; *supra* Part II.A; *infra* note 103 and accompanying text. Increased Social Security taxes generally are less than the increased credit.

<sup>100</sup> The Social Security benefit formula is a function of the amount the recipient has paid into the Social Security system through the tax on wages. *See* SOC. SEC. ADMIN., RETIREMENT BENEFITS 5 (2013), <http://socialsecurity.gov/pubs/10035.html>.

<sup>101</sup> Other excludable fringe benefits are in I.R.C. § 132, which discusses the exclusion of certain fringe benefits; I.R.C. § 106(a), which discusses the exclusion of "employer-provided coverage under an accident or health plan"; I.R.C. § 79(a), which discusses the exclusion of group-term life insurance under a certain cost; and I.R.C. § 125, which discusses cafeteria plans.

<sup>102</sup> *Id.* § 3121(a)(20) (excluding fringe benefits from wages for the purposes of Social Security and Medicare taxes).

<sup>103</sup> *Id.* § 32(c)(2)(A); *supra* note 72 and accompanying text.

<sup>104</sup> I.R.C. § 132(a)(3), (d) (working condition fringe, which is any item where if the employee paid for it, the payment would be deductible by the employee under I.R.C. § 162 (ordinary and necessary business expenses) or I.R.C. § 167 (depreciation or amortization)); *id.* § 132(j)(4) (onsite athletic facility for the use of employees and their spouses and dependents).

<sup>105</sup> *Id.* § 132(a)(1), (b) (no-additional-cost fringe, such as a travel pass for airline employees).

<sup>106</sup> *Id.* § 132(a)(2), (c) (employee discounts).

<sup>107</sup> *Id.* § 132(a)(5), (f) (qualified transportation fringe).

<sup>108</sup> *Id.* § 83(a) (inclusion of the value of property received for services).

<sup>109</sup> *Id.* §§ 3101(a)–(b), 3121(a)(20).

employee otherwise might demand, and in that way benefit the employer. Thus, while personal service income exclusions violate horizontal equity principles, they may violate vertical equity principles as well by inuring to the employer's benefit.

### III. EXCLUSIONS FROM GROSS INCOME

Permitting taxpayers to exclude some items of income that not all taxpayers with like amounts of economic income have violates the horizontal equity principle.<sup>110</sup> If higher income rather than lower income taxpayers are most often the recipients of the excluded items, exclusions violate the vertical equity principle as well. Common to both schedular and global models are various items of income that are not taxed so that global models always include an untaxed schedular-type income class. Under an expressly schedular system, failure to include an income source in any statutory class makes the income exempt. An express statutory exclusion, on the other hand, may be necessary under a global system with its all-inclusive gross income definition to make an item exempt.<sup>111</sup> Nevertheless, the IRS never sought to tax various items of income—personal injury awards,<sup>112</sup> various welfare benefits,<sup>113</sup> and Social Security payments<sup>114</sup>—even before Congress enacted express statutory exclusions for those items.

The Code currently groups together some thirty-four provisions excluding specific items from gross income<sup>115</sup> that otherwise might be considered gross income.<sup>116</sup> The exclusions can be split into two categories: (i) full exclusion and (ii) deferrals and partial deferrals. Some exclusions reflect reasonably straightforward policy decisions,<sup>117</sup> while others have historical origins that may reflect the underlying policy for exclusion.<sup>118</sup> Other provisions, in conjunction with complementary basis rules, defer the

---

<sup>110</sup> See *supra* Part II.D (personal service income exclusions).

<sup>111</sup> See I.R.C. § 61(a).

<sup>112</sup> Income Tax—Proceeds of Accident Ins. Policy, 31 Op. Att'y Gen. 304, 308 (1918) (excluding accident insurance proceeds for personal injuries); T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918) (excluding personal injury awards); see also I.R.C. § 104(a)(2) (current exclusion for personal injury awards).

<sup>113</sup> See, e.g., I.T. 3194, 1938-1 C.B. 114 (excluding lump sum Social Security benefits); I.T. 3230, 1938-2 C.B. 136 (excluding state unemployment benefits); Rev. Rul. 57-102, 1957-1 C.B. 26 (holding Pennsylvania welfare for the blind excludable from gross income). The Code includes no express provision for this general welfare exclusion.

<sup>114</sup> I.R.C. § 86 assumes Social Security benefits are generally excludable from gross income in that it currently includes a portion of Social Security benefits for some taxpayers.

<sup>115</sup> Part III of subchapter B of chapter 1 of the Code includes I.R.C. §§ 101–139A.

<sup>116</sup> See *id.* § 61(a).

<sup>117</sup> See *id.* § 112 (combat zone compensation).

<sup>118</sup> E.g., *id.* § 102(a) (gifts); *id.* § 104(a)(2) (personal injury recoveries).



recognition of gain rather than excluding income permanently.<sup>119</sup> Similarly, despite an express statutory inclusion,<sup>120</sup> the U.S. Supreme Court held stock dividends to be unrealized and nontaxable capital appreciation, rather than income within the ambit of the Sixteenth Amendment.<sup>121</sup> The current statutory exclusion of stock dividends<sup>122</sup> allocates basis between old shares and dividend shares<sup>123</sup> and results in deferral, rather than exclusion, of income. In addition, there are several exclusions, or partial exclusions, scattered elsewhere in the Code.<sup>124</sup>

While the exclusions from gross income form a schedular class of zero rate income, the historical underpinnings of many of the exclusions render conclusions about their basic distributional fairness difficult to draw. For example, Congress may have intended the exclusion for life insurance proceeds<sup>125</sup> primarily to benefit widows and children left with limited resources following the death of the family's breadwinner. Had Congress foreseen the extensive use of high face amount life insurance policies in estate planning for wealthy individuals and business ownership of life insurance on employees, Congress might have restricted the exclusion. The exclusion from gross income for the value of gifts<sup>126</sup> benefits a broad range of taxpayers, but wealthier individuals make greater use of the exclusion than do less wealthy individuals because they can make larger gifts.

The exclusion of interest from state and local governments<sup>127</sup> is more clearly skewed toward higher income individuals. This exclusion distributes the tax benefit inefficiently. It misdirects a portion of a subsidy for state and local governments to high-bracket taxpayers. Rather than pricing their obligations at a tax-exempt interest rate equivalent to the after-tax rate on taxable bond interest for taxpayers in the highest marginal rate bracket, state and local bond issuers must price to a lower than maximum bracket taxpayer in order to sell all the obligations. Highest bracket taxpayers who purchase the obligations capture part of the subsidy for themselves in the form of a higher than market after-tax interest rate while taxpayers in the lower bracket which the bonds target get a market interest

---

<sup>119</sup> I.R.C. § 109, in conjunction with the I.R.C. § 1019 basis rule, defers, rather than excludes, income from a lessee's improvement of the lessor's land, and donees of appreciated property take the donor's historical basis under I.R.C. § 1015.

<sup>120</sup> Act of Sept. 8, 1916, Pub. L. No. 64-271, § 2(a), 39 Stat. 756, 757 (including stock dividends in gross income).

<sup>121</sup> *Eisner v. Macomber*, 252 U.S. 189, 219 (1920).

<sup>122</sup> I.R.C. § 305 (excluding certain stock dividends).

<sup>123</sup> *Id.* § 307.

<sup>124</sup> *Id.* § 911 (election to exclude up to an inflation-adjusted \$80,000 of income earned abroad); *id.* § 243 (allowing a deduction to corporations on certain dividends they receive).

<sup>125</sup> *Id.* § 101(a) (excluding life insurance proceeds from gross income).

<sup>126</sup> *Id.* § 102(a) (excluding gifts from gross income).

<sup>127</sup> *Id.* § 103(a) (excluding interest on state and local obligations).

rate.<sup>128</sup> Misallocation of the subsidy to those high-bracket taxpayers violates the vertical equity principle by distributing tax revenue from lower to higher bracket taxpayers.

Some gross income exclusions inure to the benefit of someone other than the person claiming the exclusion. Exclusion of personal injury awards<sup>129</sup> inure to the benefit of tortfeasors and their insurers by decreasing the size of settlements. Similarly, exclusion of life insurance proceeds from gross income<sup>130</sup> renders life insurance a more attractive investment product, and the failure to tax the inside buildup in the value of the investment enables insurers to pay a lower rate of return on the invested funds than a fully taxable investment would pay. The exclusion for scholarships<sup>131</sup> both decreases the cost to the scholarship provider and allows the scholarship recipient to pay for education with pretax income while others must pay for their educations with after-tax funds—a violation of the horizontal equity principle.<sup>132</sup> Given the trend of colleges and universities to award scholarships based on merit rather than the student's financial need,<sup>133</sup> the scholarship exclusion's violation of the horizontal equity principle seems especially troubling.

#### CONCLUSION

The U.S. income tax is moderately schedular in structure and creates nearly separate tax bases for capital gains and other investment income, personal service income, and income exemptions. Each of those schedular elements treats taxpayers with like comprehensive incomes, but differing elements making up the comprehensive income, dissimilarly and, accordingly, violates the horizontal equity principle. With limited exceptions for features like the earned income credit<sup>134</sup> and the passive activity loss limitations,<sup>135</sup> schedularity favors higher income taxpayers

---

<sup>128</sup> If market interest rates are 10% and the highest marginal income tax rate is 35%, a tax-exempt obligation should bear interest at 6.5% to make its rate competitive with the taxable 10% interest rate. If the issuer must pay interest at 7.5% in order to sell the obligations and make them competitive for a 25% bracket taxpayer, the 35% bracket taxpayer also gets 7.5%, which is equivalent to an 11.54% taxable rate.

<sup>129</sup> I.R.C. § 104(a)(2).

<sup>130</sup> *Id.* § 101(a).

<sup>131</sup> *Id.* § 117 (excluding amounts received as a scholarship from gross income).

<sup>132</sup> With exceptions for education to improve one's existing skills in business, deductible under I.R.C. § 162(a) (which concerns ordinary and necessary business expenses), education expenses generally are nondeductible living expenses under I.R.C. § 262. A limited deduction is available under I.R.C. § 222, and there are also limited "Hope and Life Learning credits" under I.R.C. § 25A. Compare discussion of excludable personal service income and horizontal equity, *supra* Part II.D.

<sup>133</sup> William R. Doyle, *Changes in Institutional Aid, 1992–2003: The Evolving Role of Merit Aid*, 51 RES. HIGHER EDUC. 789 (2010) (identifying decreased responsiveness in various aid sectors to need and greater responsiveness to academic characteristics).

<sup>134</sup> I.R.C. § 32.

<sup>135</sup> *Id.* § 469.

such that schedularity violates the fundamental vertical equity principle as well. While the income tax purports to include “all income from whatever source derived”<sup>136</sup> in a single tax computation, it does not. Rather, the income tax treats income of differing types or from differing sources dissimilarly and causes taxpayers with like amounts of economic income to become subject to differing taxes and higher income taxpayers to become subject to taxes at rates equal to or even lower than lower income taxpayers.

---

<sup>136</sup> *Id.* § 61(a).

